STANDARD & POOR'S

RATINGSDIRECT®

July 31, 2007

San Diego County, California; Appropriations; General Obligation

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Credit Profile		
San Diego Cnty GO Pension		
Long Term Rating	AA/Stable	Upgraded
San Diego Cnty certs of part (North & East Cnty Justice Facs Rfdg) ser 2005 (AMBAC)		
Unenhanced Rating	AA(SPUR)/Stable	Upgraded
San Diego Cnty certs of part (1998 Downtown Courthouse Rfdg) (AMBAC)		
Unenhanced Rating	AA(SPUR)/Stable	Upgraded
San Diego Cnty certs of part (1999 East Mesa Detention Fac Rfdg) (AMBAC)		
Unenhanced Rating	AA(SPUR)/Stable	Upgraded
San Diego Cnty certs of part (2001 MTS Tower Rfdg) (AMBAC)		
Unenhanced Rating	AA(SPUR)/Stable	Upgraded
San Diego Cnty certs of part (2005 Edgemoor Proj & 1996 Regl Comm Sys Rfdg) ser 2005 (AMBAC)		
Unenhanced Rating	AA(SPUR)/Stable	Upgraded
San Diego Cnty COPs (Edgemoor II Proj) ser 2006 (AMBAC)		
Unenhanced Rating	AA(SPUR)/Stable	Upgraded
San Diego Cnty GO pension (FGIC)		
Unenhanced Rating	AA(SPUR)/Stable	Upgraded
San Diego Cnty GO pension (MBIA)		
Unenhanced Rating	AA(SPUR)/Stable	Upgraded
San Diego Cnty GO pension (XLCAPITAL)		
Unenhanced Rating	AA(SPUR)/Stable	Upgraded
San Diego Cnty ICR		
Long Term Rating	AA+/Stable	Upgraded

Many issues are enhanced by bond insurance.

Rationale

Standard & Poor's Ratings Services raised its issuer credit rating (ICR) to 'AA+' from 'AA' on San Diego County, Calif., and raised its underlying rating (SPUR) on the county's outstanding pension obligation bonds (POBs) and certificates of participation (COPs) to 'AA' from 'AA-'. The raised ratings reflect the county's increasingly strong financial profile and a continued robust and diversified underlying economic base.

Specific credit strengths supporting the raised rating include:

- Increasing unreserved fund balances due to conservative financial planning, continued strong revenue growth, and prudent expense management;
- Recently enhanced financial management policies, including a formalize reserve policy requiring a minimum reserve of 17% of discretionary revenues, although actual reserve designations are much higher;
- A track record of consistent operating surpluses in the general fund despite increased program spending, debt

defeasance, and cash funding of projects;
- A deep and diverse economy that exhibits continued strong growth in employment, assessed valuation (AV), gross regional product, tourism spending, and especially commercial and industrial development; and
- A moderate and manageable debt burden without significant additional general fund-related bonding plans, and usage of ongoing revenues for one-time, discretionary projects.

Offsetting credit weaknesses include the fiscal pressures and exposure related to the County Medical Service (CMS) program's rising indigent-care costs and related unsettled litigation, as well as a relative slowing of the residential real estate sector.

The rating on the county's outstanding COPs reflects the county's covenant to budget and appropriate lease payments and annual appropriation risk.

The county has a Standard & Poor's Debt Derivative Profile (DDP) overall score of '1.5' on a four-point scale where '1' represents the lowest risk. The overall score of '1.5' reflects Standard & Poor's view that the county's general fund-related swap portfolio reflects a very low credit risk at this time.

San Diego County (population 3.1 million) enjoys a diverse economy that includes tourism, international trade, military, and high-tech manufacturing. Its unemployment rate continues to be below the state and national averages at 4.0% versus 4.9% for the state and 4.6% for the nation in 2006. Leading employers in San Diego County largely include the government, education, military, and health care, all very stable sectors by nature. Median household and per capita income levels are 12% and 4%, respectively, above the national average. County AV grew 9.4% in fiscal 2008 alone to $389 billion after increasing 10%-13% the previous four years. Market value per capita is now a strong $125,660 as of fiscal 2008.

San Diego County's financial position grew even stronger in fiscal 2006, driven by continued strength in the local economy. Audited fiscal 2006 general fund revenues grew 12% to $2.55 billion in fiscal 2006, with property taxes increasing a large 11%. Given various expenditure savings, the general fund ended fiscal 2006 with a $232 million surplus, more than double the strong $115 million surplus recorded in 2005. This brought the county's 2006 unreserved fund balance to $626 million or 22% of expenditures, with the undesignated portion rising $171 million to $436 million or 15% of expenditures. In its preliminary estimates for fiscal 2007, the county is projecting an unreserved fund balance of $690 million or 21% of expenditures, with the undesignated portion at $480 million or 15% of expenditures, a $44 million increase from 2006. Continued positive financial results in the general fund demonstrate the county's continued strong economic growth, which has translated into revenues far exceeding budget. When combined with strong expenditure controls, these results have enabled the county to bolster its reserve positions, avoid bonding by cash funding various projects, and pay down debt. The budget for fiscal 2008 is balanced.

The county's management practices are considered 'strong' under Standard & Poor's Financial Management Assessment (FMA). An FMA of 'strong' indicates that practices are strong, well embedded, and likely sustainable. The county has formal written policies that cover investment, swap, and debt management policies, and a new policy that requires reserves of no less than 17% of discretionary revenues. Investment results are reviewed monthly, and actual to budget variances for general fund revenues and expenditures are also reviewed monthly on a monthly basis. The county also engages in multiyear financial planning, with a five-year forecast, and its capital plan also covers a period of five years and fully identifies potential funding sources and uses of funds.

The county's overall direct and overlapping net debt burden is approximately $2,635 per capita and 2.1% of AV.

Outlook

The stable outlook reflects the county's deep and diverse economic base, strong reserve levels, formalized reserve policies, manageable debt burden, and a long track record of consistently strong financial management practices. The county's robust economy, when combined with very strong management practices, is expected to result in continued strong margins and contingency reserves, reduced or limited additional debt, and the ability to provide funding for critical capital projects. Should the county's exposure to the CMS program materialize in the form of substantially higher costs, we will assess the additional burden in light of the county's reserves in place and other potential solutions.

Economy Resilient Despite Residential Real Estate Slowdown

San Diego County has an estimated population of 3,098,000 and is located in the extreme southwestern corner of California, with the city of San Diego the county seat. The county encompasses more than 4,255 square miles and its diverse economy includes tourism, international trade, military, and high-tech manufacturing. Within the high-technology industry, employment opportunities are diversified among aerospace and defense, biotech, telecommunications, electronics, miscellaneous, software, and computers. Leading employers include the U.S. Navy (42,000 employees), the federal government (39,100), the state (37,100), University of California at San Diego (24,790), San Diego Unified School District (21,703), the city of San Diego (20,700), and the county itself (18,900). The county's unemployment rate continues to be below the state and national averages at 4.0% versus 4.9% for the state and 4.6% for the U.S. in 2006. Per capita income is about 4% greater than the national level and 5% higher than the state level. Median household income levels are 12% higher than national levels but just 2% above state levels.

San Diego continues to be a top entertainment and leisure destination, assisted by San Diego Padres' Petco Park in the downtown area, the successful and flourishing downtown convention center and Gaslamp Quarter, the world-famous San Diego Zoo and Wild Animal Park, Sea World Marine Park, and the county's temperate climate and proximity to neighboring Los Angeles and Mexico. The visitor industry is the county's third-largest in terms of income generation behind manufacturing and the military. Visitor revenues in the county were $7.7 billion in 2006, up a healthy $495 million or 7% from 2005 levels. The county's location adjacent to the Mexican border, one of the busiest border crossings in the world, helps to mitigate U.S.-based tourism declines. Given the county's favorable climate, strong tourism and employment diversity, the county has continued to enjoy positive growth in its gross regional product every year since 1996.

While the residential real estate market has slowed recently in the county, strong new commercial growth and property transfers continue to contribute to growth in AV and property tax revenues. Total residential units sold decreased 22% in June 2007 versus June 2006, with the average sale prices declining more moderate 2%. Similarly, the S&P/Case-Shiller national housing index composite shows a 2.1% decline in median sales price for existing single-family residences (April 2007, year-over-year); the localized index for the San Diego market over the same period depreciated a larger 6.7%.

Home foreclosures and loan defaults recorded have increased recently given the prevalence of subprime home mortgage loans. For the three calendar years from 2003-2005, an average 12% of notices of loan default resulted in foreclosures; this percentage rose to 20% in 2006 and 32% through March 2007. In addition, from 2003-2005, an average of 0.26% of total deeds recorded were followed by foreclosures. This percentage increased to 1.25% in 2006 and was at 3.8% through March 2007.

Countering the softness in the residential real estate market is a continued strong commercial and industrial market, with changes in ownership and new construction during 2004-2006 at strong levels, including many hotels in the area recently changing hands. Despite the soft residential market, county AV grew 12% in fiscal 2007 and an additional 9% in fiscal 2008 to $389 billion. AV has shown consistent growth, increasing at an average annual rate of 10% since 1998. Market value per capita is now a strong $125,660 as of fiscal 2008, up from $78,378 in fiscal 2003. The tax base is diverse, with the 10 leading taxpayers representing just 2.8% of total AV.

County Financial Condition Continues To Strengthen

San Diego County's financial position demonstrated another year of improvement in fiscal 2006, and fiscal 2007 is also indicative of very strong operating results. Key to the county's continued general fund operating surpluses has been better-than-budgeted revenue growth in virtually every major category, and the county has continued its track record of excellent expenditure controls.

The strength in the local economy continues to drive the county's strong financial performance, with positive economic growth occurring every year since 1994 and a property tax base that has increased an average of 10% annually since 1998. Audited fiscal 2006 general fund revenues grew 12% to $2.55 billion in fiscal 2006, with property taxes growing a large 11%. Because of various expenditure savings, the general fund ended fiscal 2006 with a $232 million surplus, more than double the strong $115 million surplus recorded in 2005. This brought the county's 2006 unreserved fund balance to $626 million or 22% of expenditures, with the undesignated portion rising $171 million to $436 million or 15% of expenditures. The county is projecting an unreserved fund balance of $690 million or 21% of expenditures for fiscal 2007, with the undesignated portion at $480 million or 15% of expenditures, a $44 million increase from 2006. For six consecutive years now, the county's fiscal year (2007 unaudited) results have been substantially better than third-quarter forecasts have indicated.

Designated county reserve levels remain strong. The county has maintained its general fund reserve designation of $55.5 million, consistent with fiscals 2003 through 2006, with its general fund contingency reserve recently increasing in fiscal 2007 to $20.0 million from $15.6 million. These two reserves, totaling a combined $75.5 million, represent 8% of discretionary revenues and 3% of expenditures. The county recently formalized its reserve policies and now requires a minimum of 10% of discretionary revenues be held as unappropriated fund balance. In practice, the county has far exceeded this policy, with an estimated unappropriated fund balance in fiscal 2007 of $263 million or 29% of discretionary revenues (8% of expenditures). The county also has additional reserves and resources of approximately $604 million that could be made available given board approval and/or modification of existing ordinances and board policies.

Continued positive financial results in the general fund demonstrate the county's continued strong economic growth, translating into revenues far exceeding budget. These results, when combined with strong expenditure controls, have enabled the county to bolster its reserve positions, avoid bonding by cash funding various projects, and pay down debt. In fiscals 2005-2007, the county contributed $90 million to its pension system above the required contribution. The county recently cash financed an $80 million medical examiner office and plans to cash fund $31 million in minor capital projects in 2008. The county also plans to prepay $100 million in outstanding bonds in 2008 and will be able to expand various services without significant impact to the county's reserves. The county anticipated the recent strong revenue growth to eventually moderate but has been prudent to use these recent "one-time" revenues for one-time expenditures. Additionally, ongoing revenues have been used for one-time capital projects so that should those recurring revenues wane, discretionary spending can be curtailed.

The fiscal 2008 budget is balanced with all labor negotiations completed, extending through 2009. The total adopted general budget is $3.5 billion with current property taxes representing 15% of budget. Total discretionary revenues are estimated at $963 million, representing a 6% increase over 2007 levels.

Financial Management Assessment: 'Strong'

The county's management practices are considered 'strong' under Standard & Poor's Financial Management Assessment (FMA). An FMA of 'strong' indicates that practices are strong, well embedded, and likely sustainable. The county has formal written policies that cover investment, swap, and debt management policies and a new reserve policy that requires reserves of no less than 17% of discretionary revenues. Investment results are reviewed monthly, and actual to budget variances for general fund revenues and expenditures are also reviewed monthly on a monthly basis. The county utilizes various external and internal resources to generate budget assumptions, including various economic publications and its own historical trend analysis. The county also engages in multiyear financial planning, with a five-year forecast, and its capital plan also covers a period of five years and fully identifies potential sources and uses of funds. Financial forecasts have historically made conservative assumptions about revenue growth and somewhat less conservative assumptions about expenditure growth, with a resulting pattern of annual operating surpluses.

Pension And Other Postretirement Employment Benefits (OPEB) Liabilities

The county's pension unfunded accrued actuarial liability (UAAL) fell to $1.23 billion as of June 30, 2006, from $1.38 billion as of June 2005, a decline of $146 million, or 11%. The reduction in the UAAL was primarily due to respective positive investment returns of 21%, 14%, and 15% in 2004, 2005, and 2006, and an additional discretionary contribution from the county of $65 million in fiscals 2006 and 2007 (after a $25 million incremental voluntary contribution in 2005). The county system's funded ratio (valuation of assets available for benefits divided by total actuarial liability) rose to 83.6% as of June 30, 2006, from 80.3% as of June 30, 2005. The county aims to maintain a funded ratio greater than 80%. As such, the county projects its funded ratio to rise to 93% by 2008. The county's general fund contribution to the pension fund in fiscal 2007 was approximately $241 million, or 7% of expenditures.

The San Diego County Employees Retirement Association (the "association") offers a health benefit to its retirees. However, retirement law does not require the association to provide postretirement health care payments, and county counsel has opined that the county has not entered into any agreements that require the county to maintain postretirement health care benefits. The association's payment thereof is an unvested benefit, cancellable at any time by the association. Regardless, the association has provided postretirement health care benefits for many years. Employees with 10 or more years of service before retirement are eligible for a monthly medical allowance from $200-$400 depending on years of service and Medicare eligibility. As of 2005 an actuarial valuation indicated a $640 million liability associated with OPEB, with $217 million of this liability funded from its designated health reserve, representing 34% of the total liability. In December 2006, the county adopted a resolution whereby members entitled to the highest vested retirement payments (Tier A members) will no longer receive a subsidy but instead will receive a taxable pension supplement payable from the county's updated $164 million health benefit reserve balance, sufficient to fund benefits for 10-11 years, with no county contribution required. The OPEB liability for the remaining members is estimated at $236 million with an annual required contribution of $23.6 million.

Although the county does not operate a county hospital like many other counties in the state, it still faces a moderate degree of fiscal pressure related to the need to serve indigent patients through its County Medical Services division, a health care program that treats approximately 21,000 patients per year. In May 2007, a state appellate court ruled that the county cannot deny medical care to poor citizens with serious illnesses because their incomes exceed the $1,078 monthly cap (single person; later revised to $1,103). The county's cap is lower than most other counties in the state that have caps, limiting the county's liability. The county appealed the decision in early July 2007 by arguing the inability to afford such costs, and a decision is expected by September 2007. In the meantime, on July 24, 2007, the county revised its policy so that 900 additional indigent patients would be served, with the income cap rising to $1,404 and copayments required for patients between 135% and 165% of this cap. The additional cost to the county is estimated at $3 million annually, on top of a CMS budget of $67 million. The impact of this recent policy change is very small given the county's financial position, but the exposure related to future adverse rulings could be greater. However, given the county's substantial reserves and history of strong general fund surpluses, the exposure is expected to be manageable.

Debt And Capital Plan Manageable

The county's latest capital improvement needs assessment for 2007-2012 has identified a list of projects totaling $1.3 billion, including both funded and approved projects as well as unfunded projects. Additional bonding via the use of COPs will likely be required for some projects, although the exact timing and amount are uncertain. The county's goal is to maintain its long-term debt carrying charge at less than 5% of budget, with a maximum variable-rate debt exposure of 15% of total outstanding long-term debt. The county's overall direct and overlapping net debt burden is approximately $2,635 per capita and 2.1% of AV. Because the county has no outstanding GO debt, most of the county's debt takes the form of POBs and COPs, which are secured by general fund appropriations. Not including the early repayment of $100 million in outstanding bonds scheduled for fiscal 2008, debt servicing is expected to consume a small 2.1% of the county's general fund.

Debt Derivative Profile

The county has been assigned a DDP overall score of '1.5' on a four-point scale where '1' represents the lowest risk. The overall score of '1.5' reflects Standard & Poor's view that the county's general fund-related swap portfolio reflects a very low credit risk at this time due to the following factors:

- Highly rated swap counterparties,
- A low degree of involuntary termination risk under the county's swaps due to a moderate ratings trigger spread,
- Strong economic viability of the swap portfolio over stressful economic cycles, and
- Good management practices including formalized debt and swap management plans and policies.

The county has two swaps outstanding--one for $263 million notional with Citibank NA New York ('AA/Stable') and one for $142 million with Morgan Stanley Capital Services Inc. ('A+/Positive'). The swaps score a '1' for termination risk due to the minimal likelihood of involuntary termination due to a lowered rating on the county over the long term.

The county's total floating-to-fixed swap notional outstanding is $405 million as of November 2006. The effective date of the two swaps (entered into simultaneously) outstanding was Sept. 17, 2002. The amortization or decline of swap notional amount begins in August 2016, declining to just under $200 million by 2025, and to zero by February 2031. On a pro forma basis, net variable-rate exposure is a manageable $100 million or 6% of current general fund-related debt, versus the county's policy maximum of 15%.